

*Giving Thought* discussion paper no. 2

# Returns Policy?

What the next decade holds for social investment

September 2014

## 1) Introduction

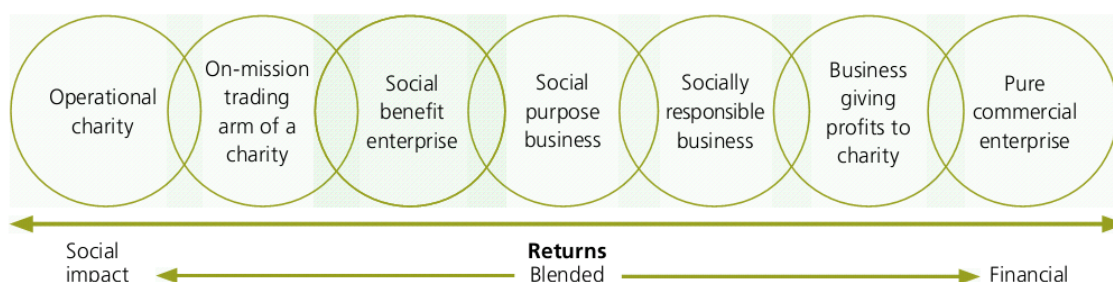
Social investment – the intentional use of money to produce a combined social and financial benefit through investing – is an idea that has been around for some time, but is now starting to creep into the mainstream. Over the last few years we have seen social investment initiatives hit the news around the world, from the US (where it is more commonly called impact investing) to India and we have seen policymakers sit up and take notice of social investment as a way to address pressing social needs.

CAF has been in the vanguard of the social investment movement in the UK for more than a decade. Our social investment fund, CAF Venturesome, was launched in 2002 and marked its 400<sup>th</sup> investment deal earlier this year.<sup>1</sup> The G8 Social Impact Investment Taskforce, which was convened when London hosted the G8 in 2013, has also just published the report of its year-long investigation into the future of social investment around the world.

This seemed, therefore, like an opportune time to take stock: to reflect on where social investment has got to in the UK and to highlight what we think the key areas of focus will be over the next decade.

### CAF's role as a social investor

“Social investment” is a term used to refer to a broad spectrum of approaches. This spectrum is characterised by the level of expectation that investors have of getting a financial return, and it stretches from quasi-philanthropic funding at one end – where the desire for social return far outweighs any expectation of financial return – to quasi-commercial at the other end, where financial returns are expected to be roughly commensurate with normal market rates. The following diagram shows where different types of social purpose organisation sit on this spectrum in terms of the balance of social and financial return that they produce:



<sup>1</sup> <http://caf-venturesome.tumblr.com/post/80768392572/400-deals>

CAF's work to date has been firmly at the philanthropic end of the spectrum. This is partly because of our social investment activity has evolved from our long-standing support for charitable giving and partly because we believe that this is the most effective way for us to address an ongoing market failure in terms of access to capital for charities and social enterprises. We have focused on offering low-cost repayable finance with a view to recycling our capital so that we can use it again, rather than focusing on trying to generate profits.

This makes us a bit atypical, in that the money we invest has already passed the "charitable threshold" at which charitable tax advantages come into play. This means that it would be impossible for any returns to be used to provide private benefit to investors. This puts us slightly at odds with the prevailing policy narrative around social investment in the UK, which has been increasingly focused on the idea that it is possible to generate financial returns for investors as well as social returns, and that there need not necessarily even be a trade-off between the two.

This idea that it is possible to generate "win-win" social investment opportunities, in which there is no need to trade off financial returns in order to generate social ones, has been enthusiastically promoted by the more bullish advocates of social investment.<sup>2</sup> We would certainly agree that this is an enticing vision and a laudable thing to aim for. The danger, however, is that these advocates overstate their case, and risk doing social investment a disservice by raising false expectations.<sup>3</sup> This is not to be pessimistic, only to acknowledge that since the majority of social needs we face in our country are ones that hundreds of years of philanthropic activity (not to mention the creation of the welfare state) have failed to solve, it seems optimistic to suppose that we can find new ways of meeting those needs that not only produce better social outcomes but also generate meaningful financial returns.<sup>4</sup>

CAF has always maintained that it is vital the philanthropic end of the social investment spectrum is not ignored. This is important for two main reasons: firstly it is the case that many of the financial needs of charities are ones that can only be met by funding that is primarily concerned with social, rather than financial, value, and is thus willing to be more patient and tolerant of risk. Secondly, if we are aiming to develop the supply of social investment by getting more individuals involved then it

<sup>2</sup> E.g. "[Leapfrog's Kuper Says There's No Trade-Off Between Profit and Purpose](#)", *Bloomberg Brief*, 12<sup>th</sup> June 2013.

<sup>3</sup> A 2011 report from the Global Impact Investing Network (GIIN) and JP Morgan ([Insight into the Impact Investment Market](#)) found that 38 per cent of impact investors surveyed said that they would not be willing to sacrifice financial returns for social ones, and that 60 per cent of respondents did not think that it was necessary to make such a trade-off in any case. A [2013 follow-up](#) to this report found that 65 per cent of respondents were targeting "market-rate returns" from their impact investments.

<sup>4</sup> For a detailed discussion of the question of trade-offs between financial and social returns, see Brest P & Born K, "[Unpacking the Impact in Impact Investing](#)", *Stanford Social Innovation Review*, 13<sup>th</sup> August 2013. The synopsis of [a shorter version of this article](#) published in the magazine concluded that "Although it is possible for impact investors to achieve social impact along with market rate returns, it's not easy to do and doesn't happen nearly as often as many 'boosters' would have you believe."

makes pragmatic sense to start by focusing on those who already have developed philanthropic motivations, as it will almost certainly be easier to get them to extend their activities to include some social investment than it would be to convince someone with no philanthropic track record to get involved in social investment from a standing start.<sup>5</sup>

We believe that social investment at the philanthropic end of the spectrum has a crucial role to play in developing the market. This is analogous to the role that government grant funding has played in driving innovation in many commercial industries such as technology.<sup>6</sup> This philanthropically-motivated investment is also likely to remain an important element of the ecosystem in the longer term, as there will be areas of activity in which organisations have financial needs that cannot be met by traditional grant funding but where it is not possible to generate significant financial returns. Policy developments designed to stimulate social investment must take this into account, and not focus solely on aspirational “win-win” opportunities that may be few and far between in practice.

With that guiding thought in mind, there are a number of issues affecting both the demand and supply sides of the market that we think are going to shape the environment for social investment over the coming years.

---

<sup>5</sup> Which is not to say that it is not be possible to approach the challenge from the other direction, and convince commercial investors to start taking social considerations into account (a number of organisations in the social investment sector are in fact attempting to do precisely that). What is true, however, is that that these two approaches to developing social investment have different implications, so we must ensure that social investment coming from the philanthropic end of the spectrum is taken into account when formulating policy and rhetoric.

<sup>6</sup> As argued in Mazzucato M, *The Entrepreneurial State*, Demos, 2011 [http://www.demos.co.uk/files/Entrepreneurial\\_State\\_-\\_web.pdf?1310116014](http://www.demos.co.uk/files/Entrepreneurial_State_-_web.pdf?1310116014)

## 2) Demand issues

### Financial needs of charities

In our view, social investment must be first and foremost about *meeting the financial needs of not-for-profit organisations*.<sup>7</sup> A lot of the rhetoric is centred on ambitious predictions about the future of social investment or declarations about its importance as a phenomenon. But whilst outlining a vision is clearly important, if we spend too much time describing the world we want to see and not enough time addressing the world as it actually is, we risk failing to meet the needs of the many not-for-profits that could benefit from social investment right now.

This means that we may have to temper some of the bombast of those who make sweeping claims about “win-win investments” and “triple bottom lines”. The prosaic reality is that the vast majority of demand for non-grant finance from charities and social enterprises is not for exotic financial products, but for less-glamorous affordable repayable finance.<sup>8,9</sup> Delivering this might not seem quite as exciting as designing ingenious new structures, but it is crucial to the development of the social investment market. Providing easily-accessible products that meet the demand for low-cost loans is more likely to encourage the large number of charities that could form a significant part of this market to overcome their scepticism and get involved in social investment.

### Policy drivers

Government clearly plays a major role in shaping the work of charities and social enterprises – both by what it does and what it does not do. There are a number of government policies that will have a significant impact on demand for social investment. Some of these are policies that are specifically designed to stimulate such demand, but others are merely developments in the broader policy environment whose consequences (intended or not) will affect the social investment market. We consider both of these below.

---

<sup>7</sup> Whilst acknowledging that these needs may not be well understood by the not-for-profits themselves, and considerable effort may be required to identify and quantify these needs.

<sup>8</sup> The Young Foundation/Boston Consulting Group [Lighting the Touchpaper](#) report found that 95 per cent of the social investment market in 2010 was comprised of loan finance (84 per cent secured loans and 11 per cent unsecured). The City of London report [Growing the Social Investment Market: The Landscape and Economic Impact](#), published in 2013, found that loan finance still accounted for 95 per cent of the social investment market in 2011/12.

<sup>9</sup> CAF's own report [In demand: The changing need for repayable finance in the charity sector](#) (2014) found that by far the most common form of repayable finance taken on by charities and social enterprises is long term mortgages secured on assets, with short term secured and unsecured loans making up a large part of the remaining demand.

We should remember that while action by government is a major factor affecting the growth of the market, *inaction* by government is almost as important. Those areas of social need which are not currently seen as the responsibility of the state are, by definition, areas in which charities and social enterprises play a particularly important role. And as the boundaries of the state shrink in a time of public spending cuts, these areas grow and the work of the voluntary sector is more evident. The organisations working in these areas face many challenges, not least in terms of funding, so there is likely to be increasing demand for affordable capital. Social investment could thus provide a valuable lifeline for many organisations working in areas of acute need that is not met by state provision

### *Social Investment-specific policies*

In the UK, the government has an explicit agenda of supporting the development of social investment. To this end there have been a range of policy initiatives aimed at developing the market, led by the Cabinet Office.<sup>10</sup> These have included the formation of the world's first social investment wholesale finance fund, Big Society Capital (of which more later); the introduction of a tax incentive specifically targeted at investment in social enterprises<sup>11</sup> and the establishment of a range of grant funding streams targeted at various aspects of market development (e.g. the Investment and Contract Readiness Fund,<sup>12</sup> the Social Outcomes Fund<sup>13</sup>).

These developments have positioned the UK as a world leader in social investment, a position that was reaffirmed when David Cameron used the UK's presidency of the G8 group of nations in 2013 to promote social investment by holding a "social impact investment forum" at the G8 meeting in London in June of that year. Following this a taskforce was launched to investigate the issues further, which has met a number of times and has just launched its final report.<sup>14</sup>

### *General policy developments*

Despite the fact that the UK government has pushed forward a range of policy initiatives specifically aimed at social investment, it is likely that developments in the broader policy environment will have a greater impact on the development of the market. In particular, the growth of Payment by Results

<sup>10</sup> See *Growing the Social Investment Market: A vision and strategy*, Cabinet Office (2011) and also the [2012](#), [2013](#) and [2014](#) progress updates for further information.

<sup>11</sup> [www.gov.uk/government/publications/social-investment-tax-relief-factsheet/social-investment-tax-relief](http://www.gov.uk/government/publications/social-investment-tax-relief-factsheet/social-investment-tax-relief)

<sup>12</sup> <http://www.beinvestmentready.org.uk/>

<sup>13</sup> <http://www.biglotteryfund.org.uk/sioutcomesfunds>

<sup>14</sup> <https://www.gov.uk/government/groups/social-impact-investment-taskforce>

(PbR) in public service outsourcing, and the introduction of new legislation designed to speed up the transfer of local assets and services into community hands, could both have a profound effect.

### i) Payment by Results

Payment by Results opens the door to social investment in a number of ways. The most straightforward is that charities and social enterprises which take on PbR contracts find themselves facing a funding gap. This happens because the payments are end-weighted and they do not have the working capital to finance the activities required to deliver the results. Social investors interested in supporting particular outcomes can play a role here by providing affordable finance to meet this working capital requirement. This can then be repaid once results are successfully achieved and contractual payments have been made.<sup>15</sup>

This approach can be taken further, in the form of Social Impact Bonds (SIBs). These are investment vehicles based on a PbR contract to deliver agreed outcomes, made between a public sector commissioner and a specialist intermediary (the SIB arranger).<sup>16</sup> The vehicle allows a range of social investors to pool money, which is then used to finance a range of organisations to deliver the required outcomes. These investors can then receive a financial return dependent on the extent to which targets are met or exceeded.

Social Impact Bonds were first developed in the UK, but the idea has been enthusiastically adopted in other countries such as Australia, Canada and the US (where they are called “pay for success” bonds).<sup>17</sup> Social impact bonds look set to be adopted widely across many areas of public service delivery in these countries and others. However, a cautionary note was sounded by the announcement earlier this year that the flagship Peterborough prison SIB (the world’s first operational SIB) was to have the funding for its third phase withdrawn due to a change in policy by the Ministry of Justice.<sup>18</sup> This brought home the level of political risk involved in social investment structures that are reliant on specific models of public service delivery and funding.

<sup>15</sup> Further information on CAF’s views on PbR can be found in our report [Funding Good Outcomes: Using Social Investment to Support Payment by Results](#), 2012

<sup>16</sup> [http://data.gov.uk/sib\\_knowledge\\_box/knowledge-box](http://data.gov.uk/sib_knowledge_box/knowledge-box)

<sup>17</sup> <http://www.whitehouse.gov/omb/factsheet/paying-for-success>

<sup>18</sup> [http://www.civilsociety.co.uk/finance/news/content/17355/social\\_impact\\_bond\\_at\\_peterborough\\_to\\_be\\_replaced\\_with\\_alternative\\_arrangement](http://www.civilsociety.co.uk/finance/news/content/17355/social_impact_bond_at_peterborough_to_be_replaced_with_alternative_arrangement). It should be noted that the reason the Peterborough SIB lost its 3<sup>rd</sup> tranche of funding was that the Ministry of Justice decided to introduce new arrangements to achieve the same outcomes. In one sense, this marked a success for the SIB as it had clearly made the case for funding interventions designed to help short-term re-offenders. From a financial perspective, however, it clearly has to be seen as a failure.

## ii) The Social Value Act

The Social Value Act is a new piece of legislation that requires public bodies to “have regard to economic, social and environmental well-being in connection with public services contracts”.<sup>19</sup> The hope is that by making these externalities an explicit element of the commissioning process, it will make it easier for charities and social enterprises to demonstrate the wider value that they can bring to public service delivery, and thereby enable them to compete more effectively for contracts.<sup>20</sup>

The Act only came fully into force in January 2014, so its impact to date has been limited and it is difficult to offer an assessment of successful it will prove to be as a piece of policy. However, there were some concerns that the original Bill was watered down during its passage through Parliament and that this will limit its effectiveness.<sup>21</sup> The legislation may need strengthening if it is to achieve its original aim of changing the way in which public services are commissioned is strengthened). If this does happen, it is likely to boost the demand side of the social investment market. As more charities and social enterprises successfully bid to take on public service delivery contracts, there will be a greater need to meet their capital requirements, and socially-motivated investment will be an important part of this picture.

## iii) Localism and Community Ownership

The current coalition government and its Labour predecessor have both had an interest in localism. This has led to a range of policies designed to empower communities and give them greater control over local services. Most recently, this has resulted in the establishment in law of a “community right to bid” which gives communities the right to bid to take over “assets of community value” when they come up for sale. Similarly, there is a “community right to build” and a “community right to challenge”, which allow communities to exert control over the planning process and to bid to take over failing local services.<sup>22</sup>

On the assumption that “community benefit” is also a social good, these new rights potentially pave the way for huge numbers of initiatives that would qualify for, and benefit from, social investment. If community groups want to take over assets or services, they will find themselves facing significant

<sup>19</sup> <http://www.legislation.gov.uk/ukpga/2012/3/enacted>

<sup>20</sup> “Significant boost to social enterprises as the Social Value Act comes into force”, Cabinet Office press release, January 2013

<sup>21</sup> See my post “[Getting good service: Is the Social Value Act just the beginning?](#)” on CAF’s *Giving Thought* blog, March 29<sup>th</sup> 2012

<sup>22</sup> Further information on all these rights can be found at <http://mycommunityrights.org.uk/my-community-rights/>



capital requirements. The ability to access funding from investors who are motivated by social goals (and consider community empowerment to fall within this remit) could make a huge difference in terms of the extent to which community groups are able to overcome the challenges and actually take advantage of the new rights on offer.

Since 2008, CAF has managed the Community Land Trust Fund.<sup>23</sup> This is a pilot social investment fund that focuses on assisting the development of community-led affordable housing projects. The first phase of the fund came to an end in 2013 and, following an assessment of market demand, we have launched a new five-year fund.<sup>24</sup>

#### iv) Public Sector Mutual spin-outs

Part of the coalition government's vision for public sector reform is to encourage the outsourcing of services to employee-led mutuals that have been spun out of existing public services.<sup>25</sup> These new organisations will be prime candidates for social investment funding because they will have social goals as well as capital requirements and predictable revenue streams, which should make socially-motivated loan financing a feasible and attractive option.

The Cabinet Office has a £10m fund to support the development of public sector mutuals, and so far over 100 new organisations have been spun out of existing public services.<sup>26</sup> This is a reasonably healthy number, although perhaps less than the early government rhetoric would have suggested. The growth of employee-led public sector mutuals has the potential to be positive, in terms of boosting the demand-side of the social investment market. However, it does also raise a number of issues. The main one being the extent to which the emergence of these organisations will distort the market by drawing focus away from the needs of charities, and instead skew the attention of investors heavily towards public service delivery-linked opportunities to invest in mutuals.

---

<sup>23</sup> <http://www.cltfund.org.uk/>

<sup>24</sup> Alongside the CLT Social Investment Fund, managed by CAF Venturesome, the National CLT Network manages a [grant fund](#) to support emerging CLTs as they get started.

<sup>25</sup> <https://www.gov.uk/government/collections/public-service-mutuals>

<sup>26</sup> <https://www.gov.uk/government/news/cabinet-office-mutuals-reach-century-success>

### 3) Supply Issues

#### Developing Philanthropy into Social Investment

It is just as important to take real-world considerations into account when assessing the supply side of social investment as it is on the demand side. We believe that the emphasis when considering the supply side should be on building on the existing social motivations of philanthropic donors. Whilst it may be the longer-term ambition to make social investment into an asset class that can appeal to mainstream commercial investors,<sup>27</sup> the pragmatic reality is that significant growth in the marketplace is likely to come in the first instance from encouraging individuals and organisations (such as charitable foundations) to expand beyond their traditional charitable giving and experiment with social investment.<sup>28</sup>

CAF's social investment work has built on our long tradition of supporting philanthropic giving. We have done this by offering opportunities for individuals and organisations to use their money to make loans instead of grants to social purpose organisations. The power of this is that if the loans are repaid (and so far they have been – less than 6 per cent of our deals have been written off), the money can then be loaned out again (or given as a grant) to help a different organisation. This process of recycling allows capital to be used multiple times, and thus makes it go much further in terms of its impact.

The money that CAF uses for social investment is philanthropic, in the sense that it has passed the “charitable threshold” at which a tax advantage has been gained. This means that any financial returns cannot be withdrawn for personal benefit by investors; they can only be reinvested in or donated to a charitable organisation. Thus, while we act as an intermediary, opening up social investment opportunities to individuals (particularly through our Social Impact fund<sup>29</sup>), we cannot offer those funders a financial return for themselves – only a chance to recycle money that has already been earmarked for philanthropic purposes.

<sup>27</sup> E.g. de Grave I, “[Impact investment will be a ‘powerful asset class’, predicts Cohen](#)”, *Pioneers Post*, 15<sup>th</sup> October 2013

<sup>28</sup> This is backed up by the fact that the majority of impact investing worldwide currently comes from High Net Worth Individuals (HNWIs) and Family Offices, as highlighted in the World Economic Forum report, *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors*, 2013 ([www.weforum.org/reports/margins-mainstream-assessment-impact-investment-sector-and-opportunities-engage-mainstream-i](http://www.weforum.org/reports/margins-mainstream-assessment-impact-investment-sector-and-opportunities-engage-mainstream-i))

<sup>29</sup> [https://www.cafonline.org/pdf/08331\\_CAF\\_Social\\_Impact\\_Fund\\_brochure\\_FINAL-WEB\\_2705111.pdf](https://www.cafonline.org/pdf/08331_CAF_Social_Impact_Fund_brochure_FINAL-WEB_2705111.pdf)

This philanthropic slant, along with the fact the funds have passed the charitable threshold, differentiates what we do from the models often put forward in discussions of social investment, where private returns for investors are brought to the fore. However, we would argue that the sort of finance we broker plays an invaluable role in meeting the capital needs of many charities and social enterprises, and that this end of the market must not be forgotten in policy discussions.

## Charities and Charitable Foundations

Charities are not just part of the demand side of social investment; they could be important players on the supply side too. Many charities have significant assets, which they currently invest commercially in order to get a financial return that they can put towards furthering their charitable work. However, there is potential for them to use at least some of this money for social investment and thereby deliver both financial and social returns.

This is particularly true of endowed charitable foundations, where the traditional model is for income to be generated in the form of investments and then given out in the forms of grants to organisations that will deliver the foundation's charitable goals. There has been growing interest in the foundation world in recent years in the idea of "programme-related investment" (PRI), where a foundation invests some of its endowment assets in a way that is designed to further its social mission as well as deliver a financial return.<sup>30</sup> PRI has become a significant movement in the US,<sup>31</sup> and there have been signs that it is taking hold in the UK too.

The conditions exist to enable charities to make social investment, as highlighted in the revised guidance on investment by charities published by the Charity Commission in 2011 (known as CC14).<sup>32</sup> This made it clear that there is scope for charities to make both programme related investments, and what the Charity Commission calls "Mixed-Motive Investments" (MMIs).

Despite this clarification from the regulator, there is still a lot of uncertainty and unease amongst charity trustees about making social investments because CC14 does not have legal force and it is not clear to many how the guidance fits with the legal requirements on trustees. In addition, there are practical barriers such as the fact that some charities have separate trustee committees that deal with

---

<sup>30</sup> <http://grantspace.org/Tools/Knowledge-Base/Grantmakers/pri>

<sup>31</sup> Lawrence S, *Doing Good With Foundation Assets: An Updated Look at Program-related Investments*, Foundation Center, 2010 (Available [here](#)).

<sup>32</sup> <http://www.charitycommission.gov.uk/detailed-guidance/money-and-accounts/charities-and-investment-matters-a-guide-for-trustees-cc14/>

investment and spending. This means that social investment, which can be viewed as combination of the two, risks falling between two stools.

In order to overcome some of these known issues, the Law Commission recently held a consultation on the current state of the law as regards social investment by charities.<sup>33</sup> This was useful in clearing up some of the confusion and identifying the areas in which legislation or guidance needs amending. There is also an ongoing need to raise awareness and understanding amongst charities and their trustees of what social investment is and how it relates to their work and their financial planning.

## Co-mingling and Co-investment

Social investment does not just mean a single investor putting money into a single charity or social enterprise. Either because of the scale of the capital requirements, or in order to mitigate risk, many social investment deals involve multiple funders pooling their resources, which are then used to support either a single organisation or a range of organisations.

The notion of co-funding raises challenges, both practical and theoretical. The main practical challenge is that involving multiple funders significantly increases the complexity of a deal and therefore introduces additional transaction costs. It may also require the creation of a ‘special purpose vehicle’ to host and manage the investment, or the use of an existing intermediary. These additional layers inevitably add costs of their own.

An additional complication arises if a deal involves investors of different types, with different requirements and expectations. For instance, one can easily imagine a situation in which a mixture of charitable foundations, high-net worth individuals, public bodies and companies are all interested in investing in a particular social investment deal, but may have widely divergent motivations for doing so and differing expectations about the balance of financial and social returns. This kind of “co-mingling” may present a real challenge for the charities and social enterprises on the receiving end of the investment.<sup>34</sup>

Co-mingling also raises a significant theoretical issue: to what extent should social investment be used to subsidise private gain? The problem comes about if a broad range of investors are being sought, and in order to make the investment appealing to those whose primary motivation is financial (or

<sup>33</sup> [http://lawcommission.justice.gov.uk/docs/cp216\\_charities\\_social\\_investment.pdf](http://lawcommission.justice.gov.uk/docs/cp216_charities_social_investment.pdf)

<sup>34</sup> The Cabinet Office explored the idea of co-mingling and the different ways it can be done in practice in its report *Achieving Social Impact at Scale: Case Studies of Seven Pioneering Co-mingling Social Investment Funds* (2013)

who have a low tolerance of financial risk) the deal is structured so that those whose social motivation is stronger are asked to shoulder more of the financial risk in order to lower the risk for these other investors. This may be achieved in the form of guarantees or underwriting, or by tiering investment so that the more socially-motivated investors are asked to take a “first-loss” position.<sup>35</sup>

There is nothing inherently wrong with tiered investment, and it is not uncommon in the commercial arena. However, there is normally a direct relationship between risk and reward, so that those who are asked to take on more risk are also given greater reward if the investment is successful. The problem in the case of social investment is that this is not always true: those being asked to take on a subordinate position are not offered the possibility of greater financial reward, but rather are asked to accept a higher financial risk on the basis that they place more value on the possible social returns.

This is potentially problematic. Whilst it clearly makes sense as a way of structuring social investments that can appeal to mainstream investors, there is a clear ethical question about whether it is appropriate to rely on the social motivations of certain investors in order to reduce the risk profile of an investment in this way, given that it essentially amounts to using social investment to subsidise private gain.

There is also a practical question as to whether using such approaches to make the risk profiles of social investments more palatable is a good idea in the long run if it raises unrealistic expectations about the levels of risk and reward involved.<sup>36</sup> It would be better to develop a more sophisticated understanding of risk in the context of blended social and financial returns so that investors can make informed decisions about the levels of risk and reward they are willing to accept when making social investments.<sup>37</sup>

---

<sup>35</sup> An interesting case in point is the Rikers Island Social Impact Bond in the US, which is backed by a guarantee from the philanthropic foundation of former New York Mayor Michael Bloomberg. As a result, the SIB has been able to attract nearly \$10m of commercial investment from Goldman Sachs. (Further info can be found in CAF’s [Funding Good Outcomes](#) report, p.7)

<sup>36</sup> I explored these issues further in a review of the Cabinet Office report *Achieving Social Impact at Scale* ([Charity Times, June/July 2013](#), p.14)

<sup>37</sup> The report [Shifting the Lens: A De-Risking Toolkit for Impact Investment](#) from Bridges Ventures and Bank of America Merrill Lynch explores the various forms of risk facing social investors, and methods of reducing them, including co-mingling with philanthropically-motivated funding.

## Corporate Social Investment

One area of great possibility is corporate social investment. There have been some interesting initiatives to date that showcase companies getting involved in social investing, but it is clear that we have barely begun to harness the potential of engaging with the corporate world.<sup>38</sup>

We should differentiate from the outset between organisations that are using their own money for social investment, and those that are enabling others to make social investments by offering tailored products and services (although obviously some organisations may do both). Of those in the former camp, there is a further distinction between those companies who see social investment as part of their CSR activities and those that see it as potentially part of their commercial activities (even if it is a niche and high-risk part of those activities at this point). The latter are most likely to be financial institutions that are in a position to offer social investment opportunities to customers, (for example Threadneedle Investments, which has launched a “UK Social Bond Fund”).<sup>39</sup>

In the case of financial services firms, although we are currently talking about voluntary initiatives, there is a possibility that some form of mandatory social investment requirement may be imposed in future. Policymakers on both sides of the political spectrum have shown interest in the idea of a version of the Community Reinvestment Act (CRA).<sup>40</sup> This is a piece of legislation that has been in place in the US for over 30 years, which requires banks to invest in economically deprived communities by maintaining branch locations, lending to individuals and business and so on. Some have argued that a CRA could be a powerful tool in repairing some of the damage done to the reputation of the banking industry in the wake of the recent collapse, and repositioning banks as a force for good in society.<sup>41</sup>

The CRA in its original form is not strictly speaking about social investment; it is more about ensuring that communities and individuals are not excluded from mainstream banking. However, this in itself is arguably a social purpose which requires banks to think beyond pure profit considerations.

Furthermore, some of the suggested versions of a CRA being mooted for the UK have a more overt social investment element, in terms of requirements to support charities and social enterprises. None

<sup>38</sup> The European Venture Philanthropy Association (EVPA) recently released a report highlighting the social investment initiatives of a number of financial services firms, which identified some interesting best practice and also made it clear that there is scope for far more to be done. Buckland L, *Social Impact Strategies for Banks: Venture Philanthropy and Social Investment*, EVPA, 2014

<sup>39</sup> For further details, see <http://www.threadneedle.co.uk/en/Intermediary/Funds/Funds-and-Prices/Prices-Data/OEICs/Retail-%28Net%29/Fixed-Income/UK-Social-Bond-Fund/>

<sup>40</sup> For further information see Blair C & Edmonds T “Community Reinvestment Act – Commons Library Standard Note”, House of Commons Library, 2010

<sup>41</sup> E.g. The 2014 report from think tank Res Publica *Markets for the Many: How civic finance can open up markets and widen access* or the 2012 Briefing paper from the Centre on Household Assets and Savings Management at Birmingham University, “[Why the UK Needs a Community Re-investment Act](#)”

of these suggestions have been adopted so far, but the body of advocates for a CRA is growing steadily so it seems like an idea that is not going away any time soon.

Whether it is voluntary or compulsory, social investment support from businesses need not be solely financial: they can also offer in-kind help in the form of business advice, mentoring and so on that can help charities and social enterprises to become better prepared for social investment in the future. The SE Assist programme, which CAF has worked on with Legal & General, is an example of this sort of approach.<sup>42</sup> A mixture of funding and support from L&G staff in two locations (Sussex and Croydon) is offered to local social enterprises to help them develop their organisational and financial capabilities. This mixture can be a potent boost for small non-profit organisations that are looking to develop and take their work to the next level, as it can offer them invaluable assistance that they would almost certainly not be able to afford if they had to pay for it.

## Institutional and Retail Social Investment

As mentioned above, some companies would not only be able to use their own money for social investment, but would be able to bring their customers on board too. Probably the most important types of organisation from this point of view are institutional investors, such as pension funds, as they would potentially be able to offer it as an option to their investors and pension-holders and thereby bring in a huge amount of new capital. This could have a transformative effect on the social investment sector. If even a small percentage of the money held in pension and investment funds could be directed towards social investment, it would result in a dramatic increase in the supply of social investment finance.

To understand the scale of the potential, consider that 87 per cent of investment assets worldwide are owned by pension funds and insurance companies (with foundations and endowments holding only 2 per cent).<sup>43</sup> UK pension funds contain a total of £1.95 trillion of assets.<sup>44</sup> So if only 0.01 per cent (one pound in every ten thousand) of the money in UK pensions was directed towards social investment, that would mean an additional £195m. Current estimates put the value of the UK social investment market as a whole at somewhere between £150m and £200m,<sup>45</sup> so this extra money would immediately lead to the market doubling in size.

---

<sup>42</sup> For further details see <https://se-assist.co.uk/>

<sup>43</sup> World Economic Forum, *Op. Cit.*

<sup>44</sup> Towers Watson, *Global Pension Assets Survey*, 2013

<sup>45</sup> Big Society Capital, *Social Investment Compendium*, 2013

In addition to opening up social investment opportunities for pension and investment fund customers, financial services firms could also enable truly retail social investment through the development of new products for mass-market customers. The idea of a “social ISA” has already been floated,<sup>46</sup> and one could envisage more variations on the same theme.

It is unclear what level of demand there currently is for retail social investment products, and the few attempts so far to gauge demand have highlighted that there are significant challenges to be overcome if truly mainstream social investment is to become a reality. Social investment charity Allia launched a “Future for Children Bond” in 2013, which was designed to offer retail investors an opportunity to invest in social impact bonds, but eventually decided not to proceed with issuing the bond as they failed to receive a sufficient number of subscriptions.<sup>47</sup> Allia has since launched a new platform designed to allow retail investors the opportunity to invest in bonds that finance the work of charities.<sup>48</sup> Whilst it is still early days, initial signs have been very encouraging, with one of the first bonds on offer having to close subscriptions early due to the level of demand.<sup>49</sup>

Despite these encouraging signs of investor appetite for social investment, developing retail products is still not likely to be a compelling proposition for mainstream financial service firms at the moment. Part of the problem is that levels of awareness of social investment among the general public are extremely low. It is therefore not surprising that there is not a huge amount of unprompted demand for new products. Rather, demand might have to be shaped. And providing easy-to-understand products that normalise the concept of social investment could be an important part of doing this. This might mean that only socially-motivated organisations offered such products initially, as they are likely to have an interest in the wider development of social investment that commercial financial services firms are unlikely to share. It is important that we continue to look for ways to open social investment up to retail investors.

## Local Authority Social Investment

Local Authorities have the potential to be major players in the social investment market. To date their involvement has been primarily on the demand side, in their role as commissioners of public service delivery contracts which are then used to provide the basis for social investment products (such as

<sup>46</sup> “[Big Society Bank could back social ISAs for everyday savers](#)”, Cabinet Office press release, 14 February 2011

<sup>47</sup> NPC was commissioned to undertake an analysis of what could be learned from the experience of the Future for Children Bond and published a report of its findings in July 2013: <http://www.thinknpc.org/publications/the-future-for-children-bond-lessons-learned/>

<sup>48</sup> [www.retailcharitybonds.co.uk](http://www.retailcharitybonds.co.uk)

<sup>49</sup> Ricketts A, “[Golden Lane Housing retail bond closes after raising £11m](#)”, *Third Sector*, 11<sup>th</sup> July 2014



Social Impact Bonds). However, in the future Local Authorities could play a key role on the supply side too, by using their own money to make social investments.<sup>50</sup>

As organisations that have significant investible assets, but also a clear remit to deliver public value, Local Authorities seem like prime candidates to make investments that meet social as well as financial goals. Existing legislation and guidance on treasury management for Local Authorities allow sufficient leeway for this to happen, and this has recently been confirmed in practice: it was reported earlier this year that Croydon council has made a £10m investment from its treasury assets in a social impact fund that supports homeless people to get into affordable housing.<sup>51</sup>

The aim should now be to encourage more Local Authorities to follow the example set by Croydon. One of the challenges in doing this is that guidance for Local Authorities stipulates that the key criteria when considering investments are security, liquidity and yield (in that order).<sup>52</sup> As it stands, the majority of social investments are unlikely to fare well against these criteria as they tend to be high-risk, low yield and illiquid. The key will be to develop social investment opportunities that are able to meet the investment criteria of local authorities sufficiently well for their added social impact to be taken into account.

An additional challenge may be the increased aversion to risk felt by many Local Authorities in the wake of the Icelandic banking collapse in 2008. A number of Local Authorities that had significant holdings in Icelandic financial institutions were left in serious financial difficulty and may still be reluctant to consider non-standard investments, even if it can be demonstrated that they bring additional social benefits.<sup>53</sup>

## Role of Big Society Capital

Big Society Capital (BSC) is the government-backed wholesale social investment fund launched in 2012.<sup>54</sup> It has around £600m of assets – £400m of which comes from dormant bank assets and £200m which comes from four high street banks, who have each invested £50m as part of the

<sup>50</sup> As argued, for instance in, [New Finance for a New World: How local government can harness social investment for social goals](#), BDO/Solace, 2013

<sup>51</sup> <http://www.pioneerspost.com/news/20140409/croydon-council-first-local-authority-invest-10m-award-winning-property-fund>

<sup>52</sup> Communities and Local Government Committee, [Local Authority investments: Seventh report of session 2008-09](#), House of Commons, 2009.

<sup>53</sup> [Risk and Return: English Local Authorities and the Icelandic Banks](#), Audit Commission, March 2009

<sup>54</sup> [www.bigsocietycapital.com](http://www.bigsocietycapital.com)

“Project Merlin” agreement with the government relating to their broader contribution to society and the economy.<sup>55</sup>

The development of BSC has established the UK government as a world leader in supporting social investment. However, progress since its launch has not been without issues. Foremost among these is that the structure and operating principles of BSC mean that it is committed to covering its own costs and delivering a reasonable rate of return to its investors within its first few years of operation. While this is not an unreasonable aim in itself, it has led to some criticism that the interest rates BSC has to charge on its lending to intermediaries in order to meet its own requirements mean that the finance on offer is unaffordable to the majority of charities and social enterprises. Some have further argued that BSC’s commitment to self-sustainability prevents it from offering the sort of high-risk, almost grant-like finance, which would be of most use in developing the social investment market.<sup>56</sup> This is something that BSC itself has conceded more recently, and it now acknowledges the importance of grant-like funding in making its work possible, although it is still in the awkward position of being limited in its ability to offer this kind of funding itself.<sup>57</sup>

---

<sup>55</sup> “[Government welcomes banks’ statements on lending 15% more to SMEs, and on pay and support for regional growth](#)”, HM Treasury press release, 9<sup>th</sup> February 2011

<sup>56</sup> See the following articles in *Pioneers Post* for a discussion of some of the issues stemming from BSC’s self-sustainability requirement: <http://www.pioneerspost.com/news/20130801/the-cost-of-money-part-1-big-society-capital-the-hotseat> and <http://www.pioneerspost.com/news/20130802/the-cost-of-money-part-2-too-high-the-little-guy>

<sup>57</sup> For a detailed look at BSC’s evolving attitude towards subsidies, see the February 2014 interview with CEO Nick O’Donohoe by David Floyd of Social Spider CIC, “[Report From Emerging Market](#)”, on his Beanbags and Bullshit blog.

## 4) CAF's Key Principles for the next 10 years of social investment

There are clearly huge opportunities for social investment over the coming decade, but also some notable challenges that need to be addressed in order to realise its full potential. Some of these merely require time, but others will require renewed effort on the part of players in the social investment market and targeted support from policymakers. CAF does not have all the answers, but we believe there are a number of key principles that need to be maintained as the social investment market develops, if it is to benefit charities and social enterprises.

### *Demand*

- 1) **Grant funding should be used to support charities to get “investment ready”.** Many charities and their trustees need support in order to develop the skills to identify and manage their own financial needs. Existing and new sources of grant funding should be used to further this strategic aim.
- 2) **Payment-by-Results contracts must work for charities and social enterprises.** As argued in our *Funding Good Outcomes* report, we believe that PbR has huge potential but that PbR contracts have to be designed carefully if they are to work for the voluntary sector and for social investors. They should include a mixture of core funding and at-risk payments, and there must be sufficient time in the contract process for investors to perform due diligence.
- 3) **Community assets and services are a huge opportunity.** Charities and social enterprises should be supported to take advantage of the new rights to challenge local service delivery and to buy community assets.

### *Supply*

- 4) **We must not ignore the philanthropic end of the social investment market.** While there may be opportunities for “win-win” social investments that produce social value and near-market returns, we must not assume that all social investment must fit this mould. There is an

ongoing need for capital funding that is largely philanthropic, with little or no expectation of financial return beyond the return of capital, and this should be reflected in policymaking and rhetoric.

- 5) **Social investors should not be expected to subsidise private gain for commercial investors or public sector commissioners** Although guarantees, underwriting and subordinate investment are potentially powerful tools, they must not be used to leverage the motivation of social investors in order to make investment more appealing for commercial investors, or to ensure higher returns for public sector commissioners, unless the social investors also receive proportionate rewards for success.
- 6) **Charities and charitable trusts should be encouraged to consider social investment.** Legal and regulatory barriers preventing charities and their trustees from using charitable assets to make social investments should be removed. Trustees should be able to access training and information so that they can get the skills and confidence to make social investments where appropriate.
- 7) **Local Authorities should become social investors.** Local Authorities should use a portion of their treasury investment funds to make appropriate social investments. Guidance should be renewed to make it clear that this is acceptable and examples of Local Authorities already making social investments should be highlighted in order to demonstrate best practice.
- 8) **Companies should embrace social investment.** Companies should be encouraged to use their own money to support charities and social enterprises through investment as well as more traditional CSR and grant making. Companies (particularly those involved in retail finance or institutional investment) should also look to develop products and services which enable their customers to get involved in social investment.

If these eight principles are used to guide policy making, it will help to ensure that charities and social enterprises are in the best possible position to access social investment financing in the years to come, and thus that the transformative potential of social investment is realised.

For more information, contact the author of this report:

**Rhodri Davies**

Programme Leader, Giving Thought

Charities Aid Foundation

[rdavies@cafonline.org](mailto:rdavies@cafonline.org)